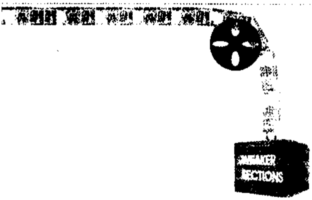
MICROCREDIT IN INDIA

Panacea for poverty?

While microcredit in India is growing steadily, the future for this segment appears to be gloomy owing to structural issues.



The term microcredit has caught the attention of people all around the world. In India, the concept of microcredit existed long before Muhammad Yunus of Bangladesh initiated the process in 1970s. In its simplest form, microcredit means lending in small amounts to the economically weaker sections for productive purposes (except in case of housing units). However, many financial institutions categorize consumer loans, say, to purchase jewelry, as microcredit on the grounds that the loans are in small amounts and they are lent to the rural people. The Reserve Bank of India (RBI) in January 2000 pegged the maximum limit of amount to be categorized as microfinance at Rs. 50,000 for a business enterprise and at Rs. 1.25 lakh for a housing unit. Several other commercial banks fix the maximum limit between Rs. 20,000 and Rs. 50,000.

In the recent past, many banks, which once ignored this area, are now showing interest in it and microfinance as a separate segment has recorded an exorbitant growth. For the nine months ended December 2003, the total asset base under this segment stood at Rs. 2,800 cr. And the number of Self-Help Groups (SHGs) stood at 7,17,306 (approximately). However, by 2007, this figure is expected to go up to 12-14 lakhs. Despite the growth record, figures show that the supply of funds in the sector is far behind the demand. In order to meet the rising demand, the sector is required to grow at an even faster pace. According to the report 'Task Force on Supportive Policy and Regulatory Framework for Microfinance in India' by National Bank for Agriculture and Rural Development (Nabard), on an average, a poor household uses a credit of Rs. 3,000 to 9,000 per annum. Going by this, the poor households, expected to be at about 50 million, will generate a demand for microcredit of Rs. 15,000 to 45,000 cr. Despite the potential, the segment's growth is bound by many regulatory hitches, which may decelerate the growth of the sector.

Putting the pieces together

As stated earlier, in its original form, microfinance existed from times immemorial in India. However, it existed in unregulated and unorganized form. Traditionally, microfinance existed in the form of loans from moneylenders, friends and relatives, credit through specialized banks and so on. The organized microcredit is advanced through rural branch networks of commercial banks, the SHG and bank linkage program initiated by Nabard, and loans through Microfinance Institutions (MFIs).

In the first model, banks use their rural branch network to extend credit to those in need after extensive credit evaluation of the borrower. Nonetheless, the model suffers from the concentration risk. For instance, a banker who spent time and money in evaluating a prospective borrower wishes to lend large amounts to that borrower so as to use the time and resources used on that particular customer effectively. Even if one such person defaults, the NPAs as a percentage of total asset base touch the sky.

In the second model, an SHG, comprising 20 women is formed by a Non-Government Organization (NGO). The members of SHG are liable for the loans jointly as well as individually. The leader takes care of raising the loans. Since the whole group is liable for the loans taken, the default risk is too low and the safety factor is involved in it. However, the magnitude of the risk depends on the members who constitute the group. Another gray area in this model is the amount required to set up the SHG. While Nabard has fixed the amount at Rs. 1,000, the NGOs have fixed it at Rs. 12,000 and the Ministry of Rural Development at Rs. 10,000.

The third model—lending through MFIs has become very popular in the recent past. The model, which was initiated jointly by the Friends of Women's World Banking and government-sponsored Rashtriya Mahila Kosh has entered such areas, which the commercial banks once labeled as most riskiest options. The prominent players that used this route to enter the segment include Small Industries Development Bank of India (SIDBI) and ICICI Bank. From 1994, when SIDBI entered the segment, till 2003, it has made disbursements worth Rs. 161 cr to 183 NGOs and MFIs that eventually reached 8.6 lakh households (according to *Business India*).

Reasons for the limelight

While microcredit has existed in India for a long period, what brought it into the limelight suddenly? There are several reasons for this. Primarily, microcredit is a win-win situation for both the parties involved in it and the economy as a whole. Since the interest rates are at par with the market levels, the rate of return is commensurate with the risk taken. Since the lenders are predominantly women, and it is done for productive purposes (except in case of housing units), the default risk is too low. Another major factor that makes microfinance special is that it alleviates, if not eliminates poverty, with a commercial perspective. Daksha Baxi, Senior Associate, Nishith Desai Associates, avers, "Microcredit has proven to be an effective and popular measure in the ongoing struggle against poverty, enabling those without access to lending institutions to borrow at bank rates, and start small businesses. The participatory nature of these projects, together with the emphasis on women entrepreneurs and employment creation, has raised hopes of reducing poverty through this approach. This in itself is a reason for the increased prominence of microcredit."

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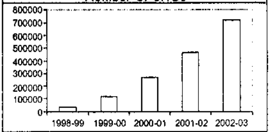
In addition to this, the RBI is pressurizing the commercial banks to increase their presence in this segment. It has mandated all the banks to preserve considerable amount of their planned advances for the sector and make their credit plan accordingly. It is because of this reason, that most of the Public Sector Banks (PSBs), earlier disinterested in this sector, are slowly increasing their presence in it. If this persists, in the coming years, microfinance is set to grow rapidly as there are many PSBs with vast rural branch networks. The primary reason why RBI is showing interest in this segment is because it contributes to the GDP, improves the standard of living of the population and thereby per capita income of the people. Put together, it reduces the burden on the government. Says N Nagarajan, Chief Economist, Indian Banks' Association: "In the absence of microcredit, the poor would have depended on the State for sustenance. If the State were unable to pacify the poor with financial palliatives, perhaps, acute and destructive social unrest could not have been avoided. In this sense, microcredit appears to have ensured the continuance of the structure of the economy as also the society, just as social security has done earlier."

Another reason for the limelight is that, since the Eighth Five-year Plan, government's emphasis was primarily on women empowerment and eradication of poverty. However, these initiatives were not backed by the right mechanism and existed ones were not up to the mark as they failed to reach the deserving poor. In this situation, microlending came as the right option to serve the right purpose. This led to the increased reliance by the government on microlending to serve its objectives.

Number of SHGs



Source: Business India

In addition to the pressure from the government, banks have identified a great potential in the sector. Banks like ICICI Bank, Deutsche Bank, and HDFC Bank are showing great interest in this sector. According to Baxi, "Microfinancing provides good business opportunity to banks such as ICICI Bank as there are some 400 million people, in six-odd million villages, who can receive small loans through microcredit. Only about 20 million of them have been served so far by the organized financial sector." Baxi further adds, "It also has minimum NPAs compared to the regular lending business of the bank. Most commercial banks would be interested in tying up with microcredit institutions to get the dual benefits of meeting their priority lending targets at lower cost of administration and lower NPAs."

In addition to this, private sector banks, which, have a comparatively poor rural branch network, are utilizing it as an opportunity to fortify it. For instance, ICICI Lombard uses the branch network of Basix, an MFI, to sell its weather insurance products. Also, microlending opens up new markets for securitization in India and contributes to the growth of the industry. Consider the case of ICICI Bank. It recently purchased Share Microfinance Limited's (SML) (an Andhra Pradesh-based MFI) outstanding loans worth $4.3 mn (Rs. 20 cr). This transaction helps ICICI Bank in many ways. Firstly, it creates business for the bank; risk is negligible as SML acts as a collecting agent for the underlying assets; it helps ICICI Bank fulfill its priority sector target set by the RBI. As Baxi avers, "Lending through microfinance would help ICICI Bank meet a government-set target of directing 40% of its total lending to 'priority sectors', including 18% to farmers. Tie-up with various microcredit organizations for this purpose enables it to reach the borrowers it could never otherwise approach. It also has minimum NPAs compared to the regular lending business of the bank. Most commercial banks would be interested in tying up with microcredit institutions to get the dual benefits of meeting their priority lending targets at lower cost of administration and lower NPAs."

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The road ahead

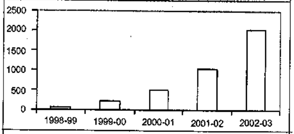
As stated earlier, in case of microfinance, demand exceeds supply. Will the players on the supply side be able to meet the demand? Certainly not. The reason being the intermediaries namely NGOs and MFIs, through which the loans are extended are in shortage and their number is expected to grow. Dr. Nagarajan says, "As for the ability of MFIs to meet the demand, one should first note the absence of such institutions. To elaborate, microcredit is being extended mainly by two sources: Banks and donor funds. These are channeled through the intermediaries called NGOs and/or SHGs. It is possible that the donor funds may dry up if the results are not to the satisfaction of the donors."

In addition to this, the growth of financial institutions in India is hampered by many regulatory hitches.

The basic problem faced by most of the MFIs is funding. Banks have to rely solely on the funds generated by the intermediaries. These intermediaries, by their very nature are not identified as financial institutions. Given their stature, they can be categorized as non-profit organizations under the regulation of Charitable Trust Act and a few provisions of the Companies Act, 1956. This prevents them from accepting deposits, be it from public or members. In turn, this prohibits these intermediaries from getting access to funds, which in turn hampers the growth of the intermediary and the members as well.

The only means by which these intermediaries can come out of this problem is to get registered as Non-Banking Finance Companies (NBFCs). The case in point is SML. SML, which, till 1999, operated as a charitable society, was later transformed into a limited company and subsequently as an NBFC. But it's not all that easy. Getting registered as NBFC requires the MFIs to follow the NBFC regulations laid down by the RBI. For instance, entities registered as NBFCs cannot mobilize savings from its members until the equity of Rs. 5 cr is attained. Also, the guidelines require these financial institutions to get rated by the rating agencies. For MFIs, which operate in small amounts and whose magnitude of operations is very small, meeting these regulations is next to impossible.

Cumulative Microcredit by Banks (Rs. cr)



Source: *Business India*

Apart from these regulatory problems, these MFIs face several structural issues. The primary one being the NGO structure, whose success and future access to funds primarily depends on the inferences and expectations of the donor rather than the demands of the market. Baxi confers, "The major difficulties faced are, lack of coordination among MFIs/NGOs for comprehensive coverage of all regions and limited ability of the MFIs to attract financial management capability." When it comes to the recovery performance, many experts opine that the current recorded performance is not sustainable in the future. The reason being, most of the borrowers are first-time borrowers and as the market grows, this trend might not continue.

Despite the great potential microfinance has, the major drawback it suffers from is that it just alleviates the poverty and does not eliminate it. Despite the rapid expansion in recent years, microfinancing fails to address the structural issues of poverty and often makes the poor vulnerable. The progress of the microfinance is measured in terms of the number of participants, recovery rate, default risk etc. The industry experts, in the zeal to drive the growth of microlending and to reap the benefits from that growth, are failing to measure the success in terms of poverty alleviation.

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Reference#01M-2004-05-05-01